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## While banks many times on the hook in check fraud cases, there are outs

Mostly check fraud schemes by employees continue to plague businesses that use traditional paper check systems. Losses can be staggering.

Recently a worker in Maryland confessed to diverting more than \$1 million by submitting fraudulent invoices to her employer and endorsing the checks to herself.

An Illinois bookkeeper siphoned \$14 million by depositing checks payable to her employer's entities into her own accounts with similar names. Other unfortunate examples abound.

Under the Illinois Uniform Commercial Code, depository or payor banks generally foot the bill for most forms of check fraud. In a tight economy, with increased automation in check processing, litigation against banks over fraudulently endorsed checks has been brisk.

Counsel for financial institutions should keep in mind while the UCC places a high burden on banks in check fraud cases, certain key provisions may provide a defense when employees dip into the negotiable instrument till.

### "Responsible employee" defense under Section 3-405

Under Subsection 3-403(a), an "unauthorized signature" — including a forgery under Subsection 1-201(41) — is "ineffective except as the signature of the unauthorized signer," which generally leaves banks on the hook for forged items.

However, Section 3-405 shifts responsibility for fraudulent employee endorsements from banks to employers, when the employee is "entrusted ... with responsibility with respect to the instrument."

Section 3-405 is conditioned on the bank having accepted the fraudulently endorsed check in

"good faith," defined in Subsection 1-201(20) as "honesty in fact and the observance of reasonable commercial standards of fair dealing."

The "responsible employee" rule applies both to inbound checks payable to employers and outbound checks issued by employers to third parties.

The rationale for this risk-shifting provision, Comment 1 explains, is that "the employer is in a far better position to avoid the loss by care in choosing employees, in supervising them and in adopting other measures to prevent forged [e]ndorsements."

### Section 3-405 liberally construed

Consistent with the express policy of incentivizing employers to supervise their workers, Section 3-405 is liberally construed to protect banks where employers fall short in monitoring financial accounts.

Initially, Section 3-405 broadly defines the term "employee" to include any person "acting in concert with the employee," such as "an independent contractor and employee of an independent contractor retained by the employer."

### *Section 3-405 shifts responsibility for fraudulent employee endorsements from banks to employers, when the employee is "entrusted ... with responsibility with respect to the instrument."*

Some courts even consider outside agents to be included under Section 3-405 as employees, as long as they have the requisite authority. *Concord Servicing Corp. v. JPMorgan Chase Bank, N.A.*, 2014 U.S. Dist. LEXIS 85627 (D. Ariz., June 24, 2014).

Next, regarding the "entrusted with responsibility" test, al-

### BANK BEAT

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most any limited employee role in issuing or depositing funds may suffice. See *Armenian Missionary Association of America Inc. v. TD Bank, N.A.*, 2015 U.S. Dist. LEXIS 121177 (D. N.J., Sept. 11, 2015) (employee was "partially responsible" within the meaning of Section 3-405 when "on a very rare occasion [he] was asked to go to the bank to deposit donation checks when the

person responsible for depositing checks was unavailable").

### Comparative negligence

Section 3-405 also includes a scale-balancing, comparative negligence test that requires banks to use "ordinary care" in "paying or taking the instrument." If "ordinary care" is not used, the employer "may recover from the [bank] to the extent the

failure to exercise ordinary care contributed to the loss."

"Ordinary care" is defined in Subsection 3-103(a)(7) as the observance of "reasonable commercial standards," and when proper automated check processing systems are used, "reasonable commercial standards do not require the bank to examine the instrument."

While "ordinary care" determined case-by-case, Comment 4 to Section 3-405 offers examples where the standard is breached:

- A bank allows an employee to open a corporate account in the name of a "well-known national corporation" without requiring resolutions or other proof of authority.
- The employee promptly deposits a check that is "for a very large amount of money."
- The employee tries to "withdraw the credit by a wire transfer to an account in a bank in a foreign country."

### Other defenses to forgeries

Even if the "responsible employee" rule does not apply, other UCC provisions may provide a defense to employee check forgeries.

First, under Section 3-404, an endorsement by an "imposter" or "fictitious payee" — for example, an employee pretending to be a vendor or posing as a fake vendor — is effective if the employee induced the employer to issue the check. Comparative negligence based on "ordinary care" applies.

Second, Section 3-406 provides banks with a defense when the employer "substantially contributes" to a forgery or alteration. If the bank failed to use "ordinary care," comparative negligence again applies.

Third, Section 4-406 requires employers to examine bank statements for unauthorized transactions and promptly notify the bank, or the claim is waived

against a bank that acted with “ordinary care.”

**Comparative negligence in “double forgery” case**

In a case that would serve well as a law school hypothetical, a trial court in Philadelphia applied comparative negligence principles in an employee “double forgery” case. The court allocated the better part of the loss to the bank for failing to follow its own deposit procedures.

In *Victory Clothing Co. v. Wachovia Bank, N.A.*, 59 UCC Rep. Serv. 2d (Callaghan) 376 (Phila. Ct. Com. 2006), a bookkeeper issued checks from her employer’s

account and made them payable to existing vendors. Next, the bookkeeper forged the employer’s signature on the front and the vendors’ endorsements on the back, then deposited the items into her personal account at Wachovia Bank.

After examining the UCC’s loss allocation rules and deciding that comparative fault principles apply to depository banks in “double forgery” cases — then a “question of first impression” in Pennsylvania — the court allocated responsibility between the employer and Wachovia.

The court determined (1) Wa-

chovia violated its own rule that checks payable to a non-personal payee must be deposited in a non-personal account with the same name; (2) the employer failed to spot his forged signature and his bookkeeper’s information on the checks; and (3) there were inadequate safeguards in the employer’s record-keeping process.

After balancing those factors, the court placed the primary blame on Wachovia for depositing corporate checks in a personal account.

“Had a single teller at Wachovia followed Wachovia’s rules,” the court predicted, “the

fraud would have been detected.”

Because Wachovia “failed to exercise ordinary care,” which “substantially contributed” to the loss, the court concluded, Wachovia was liable for 70 percent of the converted funds.

In summary, although the UCC places a high burden on banks to detect fraud in the presentment and payment of illicit checks, counsel should keep in mind that various provisions may provide a full or partial defense in employee-theft cases. Making sure the bank followed its own procedures is a vital factor.